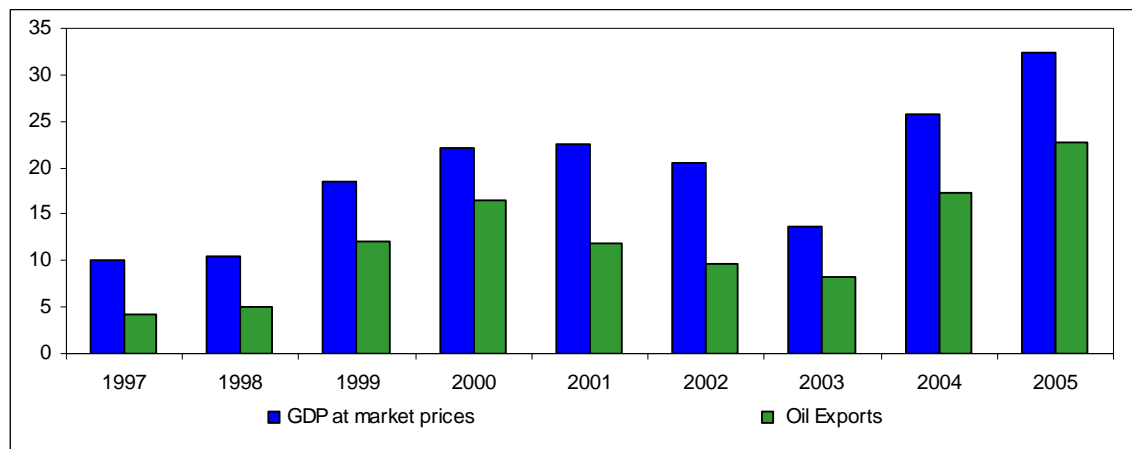


Chapter 1. Recent developments and challenges ahead

Iraqi recovery and reconstruction is progressing at a much slower pace than expected. The economy imploded in the 2003 conflict, with nominal gross domestic product (GDP) hitting a low of \$12 billion. In 2004, GDP recovered to an estimated \$25.7 billion, and income per capita rose to about \$948 (figure 1.1 and table 1.1). Almost all growth has been in the oil sector, propped up by unusually strong world oil prices. Oil production, however, has not risen above prewar levels, and other basic services, such as electricity, remain too disrupted to support strong economic growth (figure 1.2). Although the nonoil sector surged in late 2003 and early 2004, it has slowed sharply since then. GDP per capita remains less than a third of what Iraq enjoyed 25 years ago, before the economy began its decline. Recovery has generated few jobs; unemployment and underemployment are pervasive.

Figure 1.1. Iraq's gross domestic product and value of oil exports, 1997–2006

*Oil exports are recovering and driving GDP growth.
(US\$, billion)*



Note: Data for 2004–05 are preliminary estimates. GDP estimates are prone to significant errors, because of the multiple exchange rates and pricing regimes that existed prior to 2004.

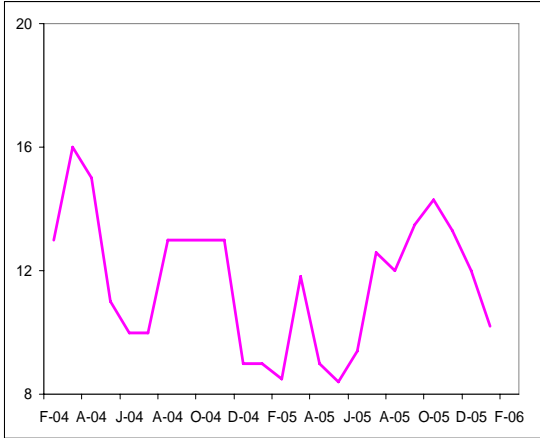
Source: World Bank and IMF staff estimates; International Energy Agency 1999.

Figure 1.2. Vulnerability of the oil and electricity sectors in Iraq

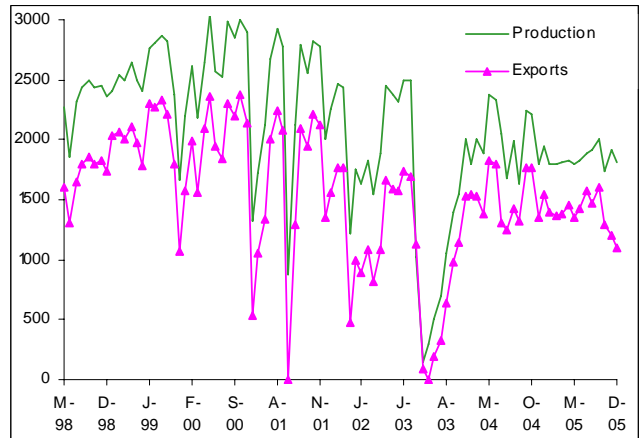
Electricity supply is inadequate...

...while oil output remains below prewar levels

Hours of electricity available daily



Thousands of barrels a day



Source: Brookings Institution, various dates; International Energy Agency 1999; World Bank staff estimates.

The state-controlled oil and gas sector dominates the Iraqi economy, accounting for about two-thirds of GDP and almost all of exports and budget receipts (excluding grants). Its recovery from the total halt in mid-2003 remains weaker than initially expected. Oil production and exports in 2004 and 2005 were at about 2 million and 1.4 million barrels per day, respectively, still below the 2000–01 levels, which themselves were about a quarter below the peak levels reached in late 1970s. Oil revenues in 2004–05 exceeded the projected levels only because of very strong world oil prices. Rundown facilities, which were starved of investment for 30 years; extensive looting in the wake of the 2003 invasion; and persistent sabotage have all hindered productivity. The short-term outlook for significant rise in oil production and exports is very uncertain. Maintaining even the current levels of production would require annual investments of \$1 billion to \$1.5 billion; boosting production further calls for much larger investment.

Table 1.1. Selected economic indicators for Iraq, 2002–05

	2002	2003	2004e	2005e
Economic growth and prices				
Nominal GDP (US\$ million)	18,970	12,602	25,724	33,182
Of which non-oil GDP (% of GDP)	33.4	33.1	32.5	38.0
Real GDP (% change)	-7.8	-41.4	46.5	2.6
Of which non-oil GDP (% change)	0.2	-40.2	14.9	8.0
GDP per capita (US dollars)	743	479	948	1189
Oil production (million bpd)	2.01	1.29	1.84	2.20
Oil exports (million bpd)	1.29	0.90	1.38	1.70
Consumer price index (% change)	19.3	34.0	31.7	32.8
National accounts				
	<i>(percent of GDP)</i>			
Gross domestic investment	–	–	26.5	29.1
Of which public	–	–	22.3	25.6
Gross domestic consumption	–	–	97.1	95.4
Of which general government	–	–	56.3	59.6
Gross national savings	–	–	-10.2	14.7
Of which public	–	–	-39.1	14.6
Fiscal and oil sector accounts				
	<i>(percent of GDP)</i>			
Revenues and grants	–	–	80.0	93.6
Of which oil revenues	50.3	69.6	69.6	67.8
Of which foreign grants	0	0	9.2	23.2
Expenditures	–	–	120.6	104.5
Operating expenditures	–	–	98.3	78.9
Of which Public Distribution System	–	–	18.6	8.4
Of which salaries and pensions	–	–	12.1	17.7
Capital expenditures	–	–	22.3	25.6
Overall fiscal balance (including grants)	–	–	-40.5	-10.9
Overall fiscal balance (excluding grants)	–	–	-49.8	-34.1
Balance of payments				
	<i>(percent of GDP)</i>			
Current account balance	–	–	-36.8	-14.4
Trade balance	-0.6	0.2	-7.0	-4.9
Merchandise exports	51.2	80.0	69.1	68.7
Of which oil	50.9	67.1	67.4	66.8
Merchandise imports	51.8	79.8	76.2	73.6
Of which OFFP	–	–	13.6	5.8
Of which refined oil products	–	–	10.3	10.3
Income and services (net)	–	–	37.5	30.8
Transfers	–	–	7.8	21.4
Financial account	–	–	42.1	18.6
Foreign direct investment	–	–	0.8	0.9
Other capital (net)	–	–	41.4	17.7
Overall external balance	–	–	6.1	4.7
Financing	–	–	-25.3	-4.2
Central Bank reserves (increase -)	–	–	-24.6	-4.2
Net change in arrears (decrease -)	–	–	-135.9	-84.3
Debt forgiveness	–	–	135.2	84.3
External public debt¹				
Estimated debt stock (US\$ billion)	–	125.0	78.2	51.2
<i>In percent of GDP</i>	–	992	304	154
<i>In percent of exports</i>	–	1240	440	225

Memorandum items

Population (millions, mid-year)	25.5	26.3	27.1	27.9
Oil prices (US\$ per barrel) ²	20.5	26	31.6	43.1
Gross reserves in months of imports	–	1.3	3.2	3.1
Exchange rate, ID per US\$1 (period average)	1957	1957	1455	1467

Notes: 2004-05 data are preliminary estimates; – is not available.

1. Debt data assume full application of the first (2004) and second (2005) tranches of the Paris Club debt rescheduling agreement by the dates stipulated by the Paris Club, and of comparable treatment by other creditors, but not the third tranche of debt relief.

2. Iraqi oil blends (Basra light, Kirkuk) are traded at a discount which reflects their lower quality and frequent supply interruptions.

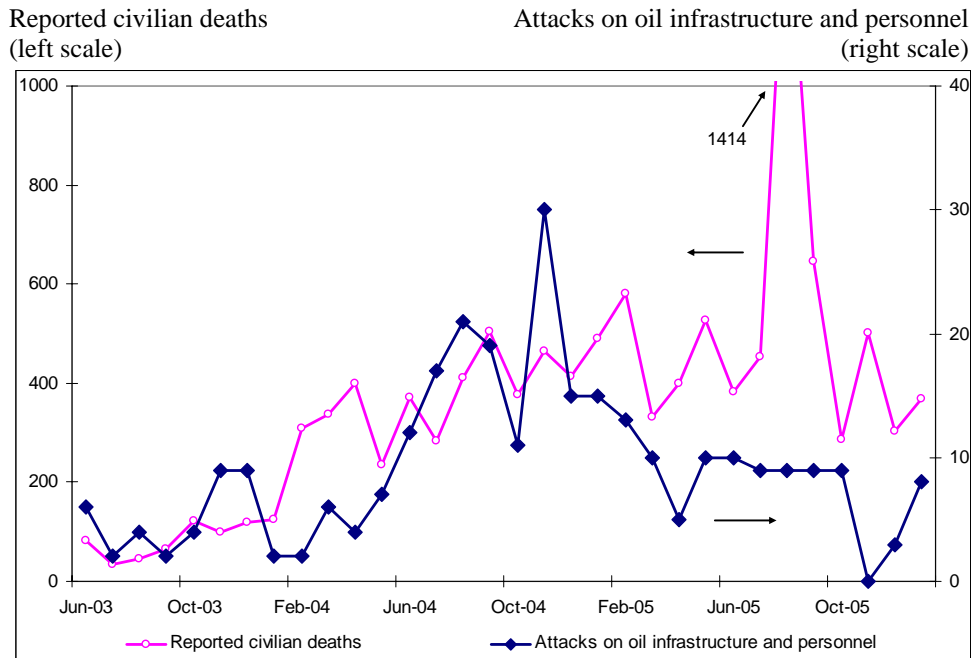
Sources: IMF and World Bank staff estimates, COSIT. Trade: UN Comtrade reported by partner countries. Oil: International Energy Agency.

Security and recovery

Rising violence continues to weigh heavily on socioeconomic revival. The incidence of conflict in Iraq in the past two decades has been three times as high as in the Middle East and North Africa region as a whole, which itself has one of the highest incidence of conflict in the world. As a result, Iraq incurred enormous losses to its social and physical capital. While formal war stopped fairly quickly, the incidence of violence has increased since late 2003 and is not abating (figure 1.3). Criminal activities (kidnappings, robberies, murders, etc.) are rampant as well. Baghdad, for example, records an average of 90 crime-related murders per 100,000 residents every month—three times higher than in most major cities in the world. Many aid organizations and private companies continue to work out of neighboring countries. While the insurgency is most intense in the centre of Iraq, attacks occur in all major cities, indicating that no part of the country is beyond the reach of hostile elements. The level of violence in Iraq remains much worse than that in postwar Afghanistan or Bosnia and Herzegovina. In Afghanistan, civilian deaths were very few after the end of the war, and cumulative foreign troop fatalities were about one-tenth of those in Iraq. Bosnia and Herzegovina saw almost no violence following the Dayton Peace Accord in December 1995 and the deployment of international peacekeepers.

Figure 1.3. Iraq’s security situation, 2003–05

Violence has continued.



Source: Iraq Pipeline Watch, Iraq Body Count; and Brookings Institution, various dates.

Studies of other conflict situations indicate a strong inverse relationship between violence and economic recovery (Putnam 2000; Keefer and Knack 2001). In Bosnia and Herzegovina annual GDP growth averaged some 62 percent in the early postwar period (1996–97). GDP per capita more than doubled from \$546 in 1995 to about \$1,300 in 1997, and social services and school enrollment improved sharply. In Afghanistan, three years after the cessation of war, annual real GDP growth averaged about 20 percent, and per capita GDP nearly doubled (from \$123 to \$200). In Iraq, in contrast, oil has propelled real GDP growth to 47 percent in 2004, but in 2005 real growth slumped to less than 3 percent. Economic activity in the nonoil sectors remains weak. Violence and corruption severely disrupt trade and investment flows and eat into reconstruction spending. Donor agencies and contractors report security and insurance outlays at 25–40 percent of the total cost of works. Since early 2004, there has been an exodus of wealthy Iraqis and their capital abroad.¹ Foreign banks that had secured licenses to operate in Iraq have yet to enter the country.

Regional obstacles to recovery. Regional disparities in security affect the strength of recovery. While the Kurdish North has also seen violence in the past two years, its levels were lower than in rest of the country, and much lower than in the Central region. Not surprisingly, nonoil economic activity was consistently stronger in the three Northern governorates (Arbil, Dohuk, and Sulaimaniya) than in the rest of Iraq. As a result, median incomes in the three Northern governorates were estimated in 2004 to be 20–25 percent higher than in the rest of the country. A substantial labor migration from the Central region to the North is reported, driven by better security and higher private-sector wages.

Iraq's social fabric remains very fragile. High unemployment, widespread poverty, and weak social protection systems are some of the problems confronting the society. Although reliable data on poverty incidence and other socioeconomic trends are spotty or absent (box 1.1), surveys undertaken in 2003–04 suggest that the incidence of absolute poverty in Iraq may be as high as 10 percent.ⁱⁱ Both monetary and nonmonetary aspects of poverty have increased dramatically in Iraq. As a result, over the past 20 years Iraq has moved away from the targets specified in the Millennium Development Goals (box 1.2). The number of widows and orphans, war wounded, and disabled grows by the day, the social exclusion of these large vulnerable threatens the fragile democracy and the reconstruction process. Apart from the universal Public Distribution System, formal safety nets cover less than 15 percent of the population and face an imminent funding crisis. The employment situation is precarious, with more than 2 million unemployed—almost 30 percent of the workforce (ILO 2004; COSIT 2003). Unemployment among young urban males is twice as high, and women's labor participation is low even by regional standards.

Box 1.1. Data quality issues in Iraq

Evaluating Iraq's socioeconomic trends remains complicated by the lack of data. The Center of Statistics and Information Technology (COSIT) in the Ministry of Planning and Development Cooperation is the leading government agency responsible for the production of nationwide data. COSIT has been working closely with the United Nations and other international agencies to meet the data needs of the government and the donor community. Elsewhere in the government, statistical capacity remains sparse.

Even basic data such as population is wanting in reliability and timeliness. The most recent census was held in 1997; population trends for later years are estimates. Recent surveys produced population estimates that differ by as much as 5 percent of the total. It is particularly hard to estimate the numbers of refugees, internally displaced persons, returning exiles, and other vulnerable groups. This paucity of data affects the estimation of development indicators and the Millennium Development Goals.

Information on household incomes and poverty is also scarce. Price and monetary data are reported regularly, but balance-of-payments and fiscal data remain incomplete. The coverage of COSIT's price indexes is unclear, as information from regions other than Baghdad is very unreliable. Very little information is available about the nonoil sector. Because communication with many parts of the country is very difficult, information on local economic trends is problematic.

International assistance for recovery. The international donor community mobilized to support the rebuilding of Iraq. UN Security Council Resolution 1483 (May 22, 2003) called for the international donor community to assist the people of Iraq in reconstruction. A conference of donors, meeting in Madrid in October 2003, pledged about \$32 billion in grants and soft loans to Iraq reconstruction. This amount included bilateral assistance programs and the donor governments' contributions to the International Reconstruction Fund Facility for Iraq (IRFFI), designed by the World Bank and the UN Development Group. IRFFI, funded in the amount of about \$1 billion, not only helps donors channel their resources, but also assists the coordination of national donor programs. IRFFI encompasses two trust funds: the Iraq Trust Fund, administered by the World Bank, and the UN Development Group Iraq Trust Fund (UNDG Trust Fund), administered by the United Nations. IRFFI is reviewed every six months at the Donor Committee meetings,

the most recent of which was hosted by the government of Jordan in July 2005. Reconstruction projects are identified and approved by an interministerial body, the Iraqi Strategic Review Board.

In December 2004, Iraq formally requested funding from the World Bank's International Development Association (IDA). Following detailed discussions between the Iraqi authorities and the World Bank, a strategy was developed to define the uses of an exceptional IDA allocation of \$500 million. The strategy also provides the framework for additional funds channeled through the World Bank Iraq Trust Fund. The Board of Directors of the World Bank approved the strategy on September 15, 2005, and by end-2005 the first IDA project was approved. A similar strategy governs the use of the UNDG Trust Fund in 2005–07. Actual aid disbursements and their reconstruction impact have been much lower than expected, because of the extreme security risks. Security costs consume 25–30 percent of the total of reconstruction assistance.

Box 1.2. Iraq and the Millennium Development Goals

Economic dislocation has led to major deterioration in Iraq's human development indicators, many of which were superior to averages in the Middle East and North Africa region just two decades ago. No official review of Millennium Development Goals has been issued in Iraq, but the country's ability to attain most of these goals appears highly uncertain at this time.

Goal 1: Eradicate extreme poverty and hunger. Reliable data on poverty are unavailable, but estimates based on recent surveys suggest that the incidence of absolute poverty can be over 10 percent, with a further 12–15 percent of the population close to the international absolute poverty line of \$1 per day. Up to 60 percent of the population is dependent on the food ration system.

Goal 2. Achieve universal primary education. By 1980, Iraq had achieved near universal primary school enrollment. Gross enrollment in primary school remains high at 102 percent. (Gross enrolment can exceed 100 percent because some children begin school early or repeat grades.) Secondary school gross enrollment, however, dropped from 47 percent to 36 percent. The attendance rate remains high at 93 percent, but is lower for girls in rural areas (86 percent). By mid-2003, some 12,000 schools were in need of repair; so far, some 3,000 schools have been rehabilitated, with repairs under way in another 1,500.

Goal 3: Promote gender equality and empower women. In 1985, Iraq's ratio of girls to boys in primary and secondary education was comparable to the Middle East and North Africa regional average of 72 percent. While the regional ratio improved steadily to reach 95 percent in 2000, Iraq's ratio only increased to 76 percent (in 1999). The ratio of young literate females (ages 15–24) to males is 50.1 percent, compared with 60 percent in Yemen, and 100.3 percent in Jordan. The gender distortion is worse in rural areas.

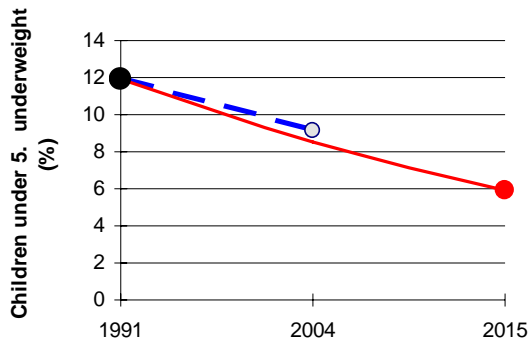
Goal 4: Reduce child mortality. During the 1970s and 1980s, key health indicators steadily improved; since 1990, however, they have deteriorated sharply again. Mortality of children under five years old reached 115 per thousand in 2003 (33 in Jordan, 107 in Yemen) and is twice as high in the South and Central regions of the country as it is in the North. Infant mortality has increased by 2002 to 102 per thousand live births (105 in Sub-Saharan Africa). It is believed that the majority of infant deaths are due to diarrhea as a result of poor water and sewerage quality and overcrowding. The incidence of the most important vaccine-preventable disease, measles, has declined since vaccine coverage improved in the 1990s, but in the North the disease is still the third most common cause of death among children five and younger.

Goal 5: Improve maternal health. Maternal mortality is extremely high at about 300 per 100,000 live births (compared with 41 in Jordan and 350 in Yemen). The share of births delivered without trained assistance in 2000 was about 28 percent nationwide and close to 40 percent in rural areas.

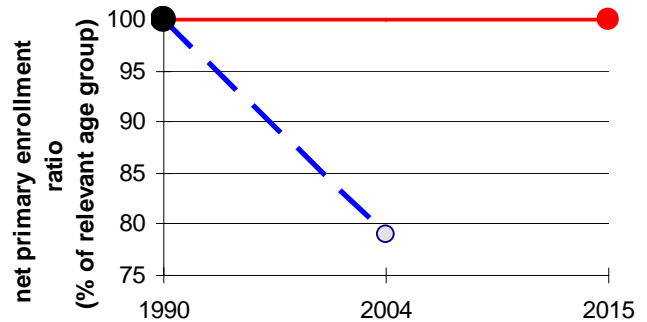
Goal 6: Combat HIV/AIDS, malaria, and other diseases. Typhoid, cholera, and malaria are endemic. In the center and south of the country the situation remains critical, with 20 percent of the population at risk from lack of access to safe water and sanitation. The reported incidence of tuberculosis (at 132 per 100,000 of population) is markedly higher than in neighboring countries. Iraq is categorized as highly vulnerable to HIV/AIDS, but no reliable data are available to support this rating. The registered number of cases of HIV/AIDS is low (about 250); however, risk factors are present for increased rates of transmission.

Goal 7. Ensure environmental sustainability. Destruction and deterioration of key ecosystems and habitats, including waterways, forests, and marshlands, are widespread. Access to improved drinking water sources has declined over the past two decades and stands at 81 percent—below the regional average of 88 percent. Emissions from the rapidly growing and often obsolete vehicle fleet and open burning of solid waste cause major air pollution. Attacks on the oil infrastructure lead to oil fires and serious air pollution over vast areas. Untreated hazardous and municipal waste accumulates as a result of fighting, while no appropriate sanitary landfills exist.

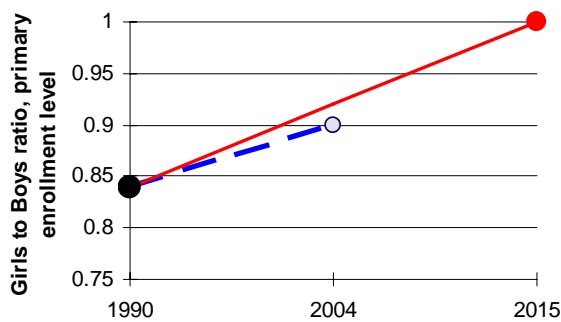
Goal 1 : Eradicate extreme poverty and hunger



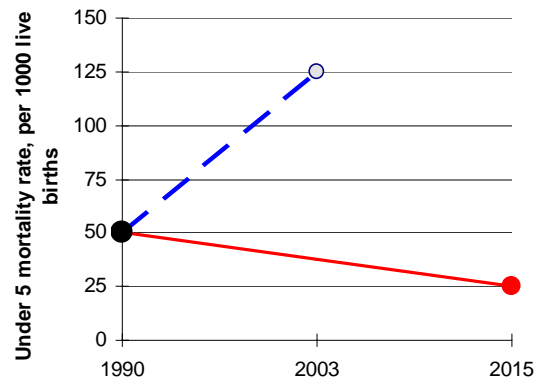
Goal 2: achieve universal primary education



Goal 3 :promote gender equality and empower women



Goal 4: reduce child mortality



— progress made

— progress needed to achieve the goal

● benchmark

● goal

○ most recent

Progress on policy and institutional reform

Early on, the authorities made progress on a variety of policy and institutional reforms. Most reforms undertaken in 2003–04 were concerned with new legislation and institutional changes: establishing a modern central bank; enacting commercial banking and anti–money laundering laws; liberalizing trade; promulgating laws on public finance, audit, and procurement; liberalizing bankruptcy and company laws; and establishing interministerial commissions on reconstruction, privatization, oil, and economic reform.

Fiscal and monetary policies. Upholding its independence under the 2004 law, the Central Bank of Iraq did not provide any new lending to the government. The Central Bank also successfully introduced the new Iraqi dinar in early 2004. Since then, and in line with its policy of securing exchange-rate stability, auctions were used in effect to peg the dinar’s exchange rate to the U.S. dollar. Since then and until late 2005 the exchange rate premiums between the street market and the auction rates remained low. Base money grew by 117 percent in 2004, reflecting rapid remonetization of the economy. This growth, however, was largely mirrored by the accumulation of foreign exchange reserves, which were equivalent to 3.2 months of merchandise imports by end-2004. Although fiscal and monetary policies have generally been prudent, pressures on the exchange rate emerged in Spring 2005, as the daily demand for currency more than doubled, probably as a result of private-sector capital flight. The accumulation of reserves has slowed significantly.

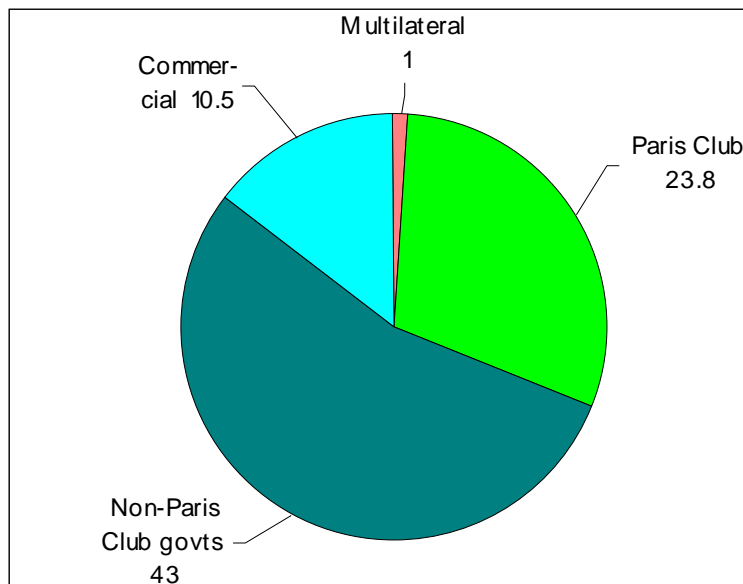
Trade policies. Important steps have been taken to liberalize Iraq’s external trade. Restrictions on trade were cancelled, and imports were subsequently subjected to a uniform reconstruction levy of 5 percent, with broad exemptions granted to imports of many humanitarian items. A national committee has been established to design a rules-based, transparent, and stable foreign trade regime that meets requirements of the World Trade Organization. These measures are intended to remove price distortions, increase competitiveness, and enhance the efficiency of the Iraqi economy. Iraq has gained an observer status in the World Trade Organization, and in December 2004 submitted a request for full membership.

International finance and debt. Iraq is reintegrating into the international financial system. The International Monetary Fund and the World Bank determined in July 2004 that they could work with the interim Iraqi government (2004–05) as the legal government of Iraq. The Iraqi authorities moved promptly to adopt their first IMF-supported stabilization framework, the Emergency Post Conflict Assistance Program, which opened the way to the normalization of external public debt. The outlook for debt sustainability was much improved by the highly concessional debt rescheduling granted by the Paris Club in November 2004. It envisaged the write-off of 80 percent of sovereign debt in three phases: (a) an immediate cancellation of 30 percent of the debt stock; (b) a further 30 percent reduction upon approval by the IMF of a Stand-by Arrangement, which took place on December 23, 2005; and (c) a final tranche of 20 percent upon completion of the IMF Board review of the third year of the Stand-By Arrangement, expected no later than December 31, 2008. The remaining debt stock is

being rescheduled over 23 years, with a 6-year grace period. By end-2005 Iraq has already signed implementation agreements with most individual Paris Club countries. It also seeks comparable treatmentⁱⁱⁱ of its debt owed to other external public and private creditors (figure 1.4). Several non-Paris Club countries have granted debt relief on terms comparable to Paris Club countries. However, progress has been very slow on renegotiating debt with GCC countries. Assessments indicate that debt sustainability would be achievable only if all three tranches of debt relief were provided in full and if other creditor groups granted comparable treatment. Under an optimistic scenario for oil prices and production, Iraq's debt-to-GDP ratio will fall below 84 percent of GDP by 2010, while the ratio of debt service to exports will decline to a manageable 6–8 percent by the end of the current decade. However, should oil production plateau at 3 million barrels per day and/or oil prices weaken, the debt-to-GDP ratio will remain above 100 percent until 2010. Debt-service payments are projected to remain low—under 1 percent of GDP until 2010.

Figure 1.4. Iraq's external public debt at the end of 2004

Governments outside the Paris Club hold about half of Iraq's debt.



Note: Amounts outstanding reflect the first tranche of debt relief granted by the Paris Club in 2004 and full comparable treatment.

Source: World Bank and IMF staff estimates.

Development strategy. In October 2004 the Iraqi government presented to the donors its first National Development Strategy, which outlined long-term priorities for reconstruction and reform. The strategy document was further updated by the transitional Iraqi government in July 2005. The strategy document offers a vision of economic revival driven by private enterprise and guaranteed by a strong and transparent public sector. The strategy recognizes that the Iraqi economy could not function well if price incentives were distorted, and charts a reform of the subsidy system, supported by strong formal

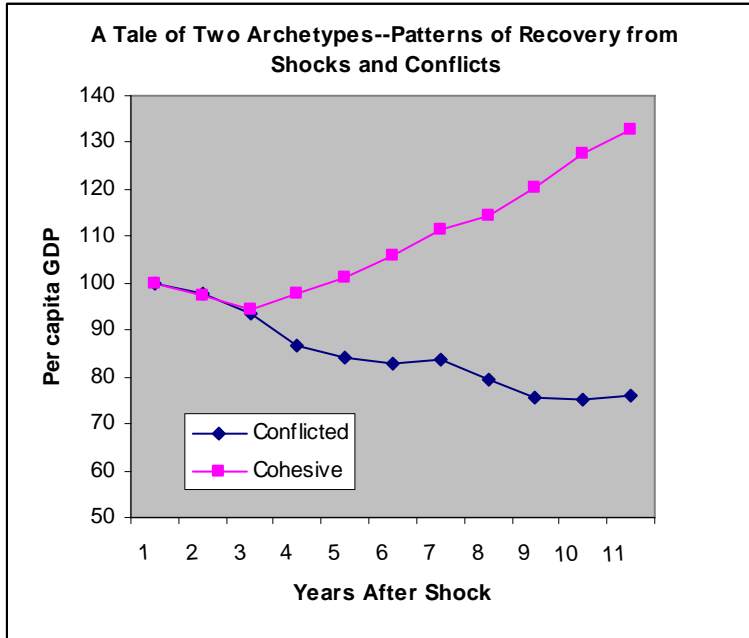
social safety nets to protect the poor and the vulnerable. The strategy seeks to establish a strong governance system in Iraq to foster fair and accountable institutions, with a particular focus on integrated budgets, strong public financial management, and a degree of fiscal decentralization. With regard to private enterprise, the strategy calls for an enabling investment climate, which will lower entry and exit barriers, and a strong legal and judicial system. The financial system is to be reformed to offer equitable access to finance for all businesses, public and private. The state will lead the rehabilitation of social services and infrastructure to ensure the supply of skilled labor and vital services. The strategy also discusses a course toward diversification, with decreasing dependence on oil exports. The National Development Strategy was welcomed by the international donor community, but has not gone far enough in offering meaningful sector strategies or reconstruction priorities.

Foundations of security and cohesion

Learning from other recoveries. One of the most important lessons from other postconflict episodes is that recovery hinges on the degree of cooperation and cohesion reached by the different sociopolitical groups. An analysis of the postconflict recovery paths in ten countries conducted for this study suggests that success in reconstruction depends on the degree to which social consensus emerges on the priorities and tradeoffs of the reform process (figure 1.5). The analysis identified two archetypes of postconflict evolution: (a) countries that manage to achieve reasonable cohesion and cooperation through domestic and external political bargaining, which produces sustained economic and social progress and (b) countries that remain mired in deep divisions and are thus unable to make headway for extended periods of time. Over the first postconflict decade, countries that develop a cohesive reform strategy outperform those that are unable to develop such a consensus by about 50 percent in terms of GDP per capita.

Figure 1.5. Patterns of recovery from shocks and conflicts

Countries with a cohesive postconflict strategy outperform those unable to develop consensus.



Note: Trends are based on the experience of ten countries: Algeria, Angola, Bangladesh, Bosnia and Herzegovina, Bulgaria, Hungary, Korea, Indonesia, Iran, and Jordan.

Source: World Bank staff estimates.

Rodrik (1999) arrives at a more generalized conclusion from the examination of growth experience in a larger sample of countries during 1960–89. His study suggests that many parts of the world, especially in Latin America, the Middle East, and Sub-Saharan Africa, have suffered large collapses in long-term growth when faced with shocks or conflicts, because they lacked internal institutions or settings to resolve the distributional conflicts that such shocks gave rise to. He suggests that “when social divisions run deep and institutions of conflict management are weak, the economic costs [of shocks from conflict-] are magnified by the distributional costs that are triggered”(p. 385). There is little doubt that such risks are currently high in Iraq. Yet, many countries with cleavages along lines of wealth, ethnic identity, geographic region, and other divisions have done very well in post-conflict situations—a trend most clearly evident earlier in East Asia (Indonesia, Korea, Malaysia, Singapore) and in more recent settings elsewhere in South Asia (Sri Lanka), Latin America (El Salvador, Guatemala), and Eastern Europe (Bosnia-Herzegovina). Two main lessons emerge. First, citizens, groups, and their political representatives can make a striking difference to their welfare and those of their children by showing a greater willingness to work out a cohesive approach to the future. Second, this effort of cohesion needs to be reinforced by clear objectives and a supporting framework of government policies. Both lessons are eminently feasible to implement and will deliver rapid recovery in economic and social conditions. Much will depend on the ability of the Iraqis themselves to fashion such a prospect.

Restoring law and order. In any conflict situation, the most critical condition for economic recovery is the end of violence and insecurity. In the case of Iraq, the two main strategies for ending violence and insecurity are: (a) building up the internal security and law enforcement institutions, so that the government is able to uphold law and order and (b) strengthening a representative form of government, so that differences are resolved through debate, representation, and contest in the political sphere, rather than in violent political conflict and confrontation. In both of these respects, progress is being achieved, with the enlargement and training of the Iraqi national security forces and with two rounds of national elections and the constitutional referendum in 2005. The immediate and critical task is to reintegrate combatants into the civil society. Successful postconflict experiences (Bosnia and Herzegovina, El Salvador, Guatemala) indicate that essential steps include providing ample civilian jobs, training, and social and economic opportunities for former combatants (as well as disarming them). The development consequences of these actions can be enormously positive, but they are expensive to design and implement. Finding the mechanisms to stop the violence in the specific circumstances of Iraq is a difficult challenge, but one that needs to be met.

A representative political system that gives a voice to all stakeholders in the society allows grievances to be resolved through negotiations and contestable elections. This task acquires particular importance in resource-rich economies, where the potential or actual flows of revenue from abundant natural resources can transform the political process into a competition for access to that revenue. In countries as diverse as Angola, Colombia, Indonesia, Nigeria, and Venezuela, natural wealth was the most powerful driver of conflict. Working out a political solution and ensuring the restoration of law and order are thus the highest priorities. Without achieving these markers of social cohesion, reconstruction and development will not happen. Sustainable political solutions demand the transparent management of national wealth. Corruption and the lack of accountability will fracture political stability and doom reconstruction.

The three main challenges ahead

Assuming that the process of reversing the violence gains credibility and restores the basic functions of representative government, the reconstruction of Iraq is likely to be shaped by three main challenges:

- *Generating growth and employment.* Key objectives for the recovery are reconstructing war-ravaged infrastructure, laying the economic foundations to generate faster and more efficient economic growth in all sectors, and giving Iraqi citizens access to an increasing number of productive jobs. Specific reforms to meet these objectives include improving the price and incentive systems, liberalizing trade, and strengthening labor market policies. The goal is to achieve an economic transformation from state domination to private entrepreneurship, from a closed to open economy, and from oil dependence to diversification.

- *Protecting the poor and the vulnerable.* Another major objective for the recovery is ensuring that poor and vulnerable social groups have access to vital services and to gainful employment opportunities. Specific reforms include shifting from universal and untargeted subsidies to strong formal safety nets, thus ensuring social safety for the poor and vulnerable and dealing with the costs of economic transition as prices are freed. Many victims of conflicts and postconflict tensions will not regain full productivity and will crucially depend on some form of social support. Opening up the economy is already hurting the poor and needs to be mitigated by efficient and targeted safety nets, as well as reform of old pension system.
- *Improving public management and accountability.* The recovery also depends critically on building more accountable institutions and transparent management of public resources, especially oil. These reforms will amount to a transition from closed to open and accountable public finances. Another important aspect of improving public management focuses on delivering public services more efficiently and responsibly. These reforms signify a transition from top-down to more decentralized and participatory public services delivery and institutions.

All three challenges need to be met simultaneously to ensure that an increasing majority of citizens share in a vision of a just and prosperous Iraq and to permit the government to undertake an ambitious transition program that lies ahead.

Redefining the role of the state

Meeting each of these three challenges requires a departure from previous role of the state in Iraq. The government will remain central to the reconstruction task, but substantively its role is likely to be very different from what it was in the past or from what is traditional for many Middle Eastern and North African countries. In the first postconflict stage the state plays the crucial role in creating jobs, rebuilding the human and physical capital of the country, and restoring population's access to vital services. In the long term, however, the state-led model cannot provide sufficient economic dynamism and job creation. In economies as diverse as Chile, China, India, and Russia, the state's role has evolved over the past 20 years to providing only essential public goods (of which law and security are the key ones), fostering a transparent and predictable business climate, and stamping out corruption. In postconflict environments as diverse as South Korea in the 1950s, Vietnam in the 1980s, and Bosnia and Herzegovina in late 1990s, most of the new jobs were created by private entrepreneurs.

The rest of this report discusses actions that Iraqi authorities may wish to consider in addressing the three reconstruction challenges. Chapters 2 and 3 propose ways to generate growth and employment. Chapter 2 discusses the immediate challenge of reviving the economy and creating more jobs, and chapter 3 considers the realignment of economic incentives and the pricing system. In examining how to best protect the poor and the vulnerable during recovery, chapter 4 addresses the issues of strengthening formal social protection and reforming the pension system. Then chapters 5 and 6 investigate options for improving public management and accountability. Chapter 5

discusses the investment regime and oil revenue management. Chapter 6 examines overarching public governance concerns, including public finance and human resource management, intergovernmental fiscal relations, and anticorruption efforts.

The pace and sequence of reform actions will need to be considered carefully. All postconflict societies are by definition fragile, and achieving social consensus in support of the reform program is essential for its success. Incentive reforms to change prices need to be expertly calibrated: some reforms are likely to proceed faster than others, so as to achieve quick returns while not hurting the socially vulnerable groups before adequate safety nets have been established. Actions to strengthen safety nets must take into account their short- and long-term costs, so as to maintain fiscal sustainability—a particularly vital concern for the high-debt situation Iraq finds itself in today. Effective public resource management is also central to delivering and prioritizing key social and infrastructural services. The menu of actions will obviously need to be tailored carefully to Iraq’s unique situation and circumstances.

Notes

ⁱ Friedrich Ebert Stiftung (2005) estimates that \$2 billion of Iraqi capital entered Jordan in 2003–04; over the first eight months of 2005, another \$2 billion entered Jordan. Iraqis accounted for over half of all Amman property purchases by nonresidents in 2003–05. As a result of this demand, Amman property values more than doubled over two years.

ⁱⁱ Using the international poverty line of \$1 per day. Iraq has neither a national poverty line nor a national report on the Millennium Development Goals. The estimates of poverty in Iraq are preliminary, as collection of poverty data is just beginning.

ⁱⁱⁱ This does not reflect comparable treatment of non-Paris Club debt in the first tranche of debt relief, which is conditional. If the first tranche of debt relief were applied to all bilateral and commercial debt, the end-2004 debt ratio would have declined to 306 percent. The Paris Club Agreed Minutes include a clause of “comparability of treatment,” which aims to ensure a balanced treatment among all external creditors of the debtor country. According to this clause, the debtor country commits itself to seek from nonmultilateral creditors, notably other official bilateral creditor countries that are not members of the Paris Club and private creditors (mainly banks, bondholders, and suppliers), a rescheduling on comparable terms to those negotiated within the Agreed Minutes.